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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	CC Docket No. 96-45
Federal-State Joint Board on Universal Service	)	CC Docket No. 97-160
Forward-Looking Mechanism for High Cost Support for Non-Rural LECs	)	DA 98-715 - USF Proposals

REPLY COMMENTS OF THE COMPETITION POLICY INSTITUTE

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Reply Comments of the Competition Policy Institute

In its Public Notice 98-715, the Common Carrier Bureau of the Federal Communications Commission solicited additional proposals to revise the methodology for determining universal service support for non-rural carriers serving high cost areas. On May 15, 1998 several parties, including the Competition Policy Institute (CPI), submitted comments in response to the Public Notice. CPI appreciates the opportunity to reply to the comments of other parties to this case. CPI is an independent, non-profit organization that advocates state and federal policies to promote competition in energy and telecommunications markets in ways that benefit consumers.

In these Reply Comments, we will review briefly CPI's proposal (presented in our Comments) for distributing high cost support to non-rural LECs and describe how that proposal compares with features of proposals described in the Comments of other parties. We will also reply to comments that addressed two other topics: 1) the use of combined interstate and intrastate revenues as a basis for assessing universal service contributions; and 2) the question of whether high cost funding is needed at this time.

A Brief Review of the CPI Proposal

CPI's proposal for sizing and distributing the federal high cost fund modifies the method adopted in the FCC's *Universal Service Order*[1], but differs from most of the other proposals currently

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[1] Federal-State Joint Board On Universal Service, CC Docket No. 96-45, Report and Order, FCC 97-150, released May 8, 1997 ("*Universal Service Order*")

before the Commission in two important ways. First, the CPI proposal offers a rational method for relating the size of the federal fund to the size of the total high cost support required. Second, the CPI proposal severs the direct link between the calculation of the total support needed and the distribution of the federal fund. Unlike the "25/75" method adopted by the Commission in its *Universal Service Order*, unlike the "40/60" proposal of TIAP, unlike the Ad Hoc proposal, and unlike the USWest "30-50" proposal, the CPI proposal computes the size of the federal fund using the same general method in the *Universal Service Order*, but then focuses the distribution of the federal high cost fund directly on high cost customers. Breaking the direct link between calculation and distribution is a critical and important feature of the method.

Under the CPI proposal, the federal high cost fund is calculated and distributed using three steps:

- The total high cost support required is calculated as the difference between forward looking economic costs and a revenue benchmark (such as the $31 residential /$51 business benchmark in the Commission's *Universal Service Order*.) For illustration purposes, assume this total is $2.5 billion.

- The federal portion of this total is set by the Commission to be a percentage of the total support required, but not to exceed the interstate retail revenue percentage[2], currently about 38%. The Commission could select a smaller federal percentage, but it should not

[2]The interstate retail revenue percentage is equal to total interstate retail revenues divided by total retail revenues (interstate and intrastate).

select a larger one.[3] For illustrative purposes, using the $2.5 billion in the above example, the federal high cost fund for non-rural LECs would be no larger than $950 million.

- The federal high cost fund would be distributed so that *100%* of forward looking economic costs per line above a uniform national "distribution threshold" would be covered by the federal fund. The "distribution threshold" would be derived so that the federal fund would be exactly spent. For illustrative purposes[4], the distribution benchmark might be $47. Under the CPI proposal then, 100% of forward looking economic costs above $47 would be covered by the federal high cost fund in this example.[5]

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[3]The reasoning behind this provision is straightforward. If the federal high cost fund supplied all needed support and used combined interstate and intrastate revenues, then interstate services would bear 38% of the total burden. But the burden on interstate revenues should not increase simply because the Commission is prohibited from considering intrastate revenues: assessments on interstate services should continue to support no more than 38% of the high cost subsidy. Stated another way, limiting the federal fund to 38% of the total ensures that the "tax rate" applied to interstate retail revenues will not be higher than the average tax rate applied by states to intrastate revenues. If the Commission is forced to work only with interstate revenues, this is a reasonable manner to divide responsibility between state and federal high cost fund efforts.

[4]We are able only to illustrate the method in these comments. The actual derived benchmark will be influenced by the cost proxy model chosen by the Commission and by the statistical distribution of line costs under the chosen model.

[5]We stress that the "distribution threshold" is not related to the "revenue benchmark" (e.g., $31 or $51) used to calculate the total high cost support required. Further, the distribution threshold does not determine the size of the federal high cost fund. Instead, the distribution threshold is the number required to spend exactly the already-calculated federal high cost fund.

Advantages of the CPI Proposal

The method proposed by CPI has some distinct advantages over some of the other distribution methods currently pending before the Commission:

1) Fair share for customers of interstate services. The size of the federal fund is limited by the interstate retail revenue percentage. This means that the assessment on carriers' interstate revenues will not exceed the average assessment on intrastate revenues needed by state high cost funds.

2) Fair share left to state funds. States would have the responsibility to cover costs below the distribution threshold, $47 in the illustrative example. No state would be left with the task of covering the costs of "supra high" cost lines through a state fund. Carriers in each state would receive federal high cost fund support in direct relationship to the high cost lines in the state.

3) Targeted federal support. The CPI proposal targets federal high cost support where it is needed most: on the highest cost customers to serve. The support will cover all costs above a distribution threshold. In this respect, the CPI proposal is similar to the existing federal high cost funds that cover all loop costs above a uniform national benchmark cost (currently 115% of national average costs).

4) Retains economic cost standard. The method calculates the total needed high cost support using a cost proxy model employing forward looking economic costs and then distributes the federal fund using the same model. This method is fair across states and avoids the problems inherent in using embedded costs to calculate and distribute high cost support.

5) Stimulus for competition in rural areas. Because federal high cost support would be targeted to high cost customers, the effect would be to provide extra incentives for competing carriers to offer service to rural high cost areas.

Relationship to Other Proposals

Because of the limitations of data, and because of the dependence on the cost proxy model selected, CPI has not calculated the "distribution threshold" under this proposal. Similarly, we have not computed the state-by-state effects of this proposal. But we can make some observations and predictions about how the CPI proposal compares to other plans advocated by commenting parties.

- If we assume that the Commission sets the size of the federal fund at 38% of the total support required, the federal high cost fund would be larger under the CPI proposal that under the FCC's "25-75" plan, but smaller than under the "40-60" proposal of TIAP. Although the fund size would be smaller than under the "40-60" proposal, the funding would be more highly targeted to high cost customers where the need is greatest.

- Because the CPI proposal focuses support on the portion of costs above a threshold, the proposal will tend to shift revenues among states to a greater extent than the Ad Hoc proposal. As we explained in our earlier comments, CPI considers this a legitimate purpose of the federal high cost fund. In fact, if the federal fund is restricted to using interstate revenues as its base for assessment, it is important that the design of the federal fund consider shifts of revenues between regions and states. If the federal fund attempts unduly to eliminate or minimize such shifts, the whole rationale for federal universal service support will be eliminated.

- Some of the proposals before the Commission incorporate features to vary support state-by-state to accommodate the differing intrastate revenues available for assessing support for intrastate funds. The CPI proposal relies on a uniform national threshold for distributing the federal support. It does not consider state-by-state differences in the intrastate revenues that will be used to support the assessment of intrastate funds.

However, the CPI proposal improves the lot of high cost states by removing directly the source of large intrastate high costs—the most expensive lines.

- The CPI proposal shares an obvious similarity with one aspect of the USWest proposal. Because federal high cost support would cover all costs above a threshold under the CPI proposal, states with a relatively greater incidence of very high cost lines would receive relatively more support. However, unlike the USWest proposal, the CPI proposal does not fund a percentage of the "mid-range" costs, between $30 and $47 (in the example). This contrasts with the feature of the USWest proposal that covers 25% of costs between $30 and $50. The comparison of these two approaches depends somewhat on the choice of cost model, but we expect that the CPI proposal would produce a smaller fund than the USWest proposal. On the other hand, the CPI proposal would produce a federal fund more focused on high cost areas than the USWest proposal.

Use of Combined Interstate and Intrastate Revenues

From the beginning, CPI has advocated that the federal universal service fund (and any state universal service funds) base their funding on an assessment against the combined interstate and intrastate revenues of interstate carriers.[6] CPI believes that, by taking the combined revenues approach, both the state and federal high cost funds are more likely to be predictable, sufficient and competitively neutral. We reiterated that position in our Comments and note that several commenters supported the use of that method. CPI supports those commenters that prefer the

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[6] See the *ex parte* submission to the Federal-State Joint Board on Universal Service, dated October 4, 1996: "An Integrated Universal Service Plan proposed by the Competition Policy Institute."

use of total revenues.[7] CPI opposes the comments of those parties that argue the Commission must or should restrict the support of the federal fund to interstate revenues.[8]

CPI urges the Commission to continue to seek an agreement with state regulators that would permit the use of combined interstate and intrastate revenues for both state and federal universal service funds. Because objections from some states may still prevent the Commission from taking that route, we offered the proposal outlined above under the assumption that only interstate revenues will be considered in the design of the federal high cost fund for non-rural carriers. If that assumption proves wrong, CPI might make a different recommendation.

When is the Federal Fund Needed?

In its comments, AT&T argues that, because local competition has been slow to develop, the Commission should defer implementation of the new system of high cost fund support for non-rural LECs. AT&T also argues that the large LECs do not require high cost support because of the size of existing support flows within the LECs' intrastate services.[9] MCI makes a related

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[7] See, for example, Comments of GTE at 17 and Comptel at 2.

[8] See, for example, Comments of the SBC LECs at 6. The discussion here about "double burdening" intrastate purchasers is especially unfortunate. The SBC LECs seem to ignore simple arithmetic: if combined revenues are used as a base for both interstate and intrastate funds, the *rate of assessment would be lower* compared to the case where only interstate (or only intrastate) revenues are considered. There would be no "double burden."

[9] Comments of AT&T at 2-13.

point: that universal service calculations should take into account the degree to which incumbent LECs have deaveraged their prices for unbundled network elements.[10]

CPI agrees with AT&T on its essential point: there is no crisis requiring high cost fund support for large non-rural LECs today. The unstated premise of Section 254 of the Telecommunications Act of 1996 was that the ravages of competition would cause such substantial market share losses to the large LECs that they would need support to continue serving their high cost customers. It was assumed that revenues from traditional sources of contribution (business lines, vertical services, intrastate access) would be reduced as competitors won customers and forced down prices.

But that vision has not materialized. Competitors have barely dented the local market. Effective competition for carrier access services remains a theory. Meanwhile, the interstate and intrastate earnings of non-rural LECs remain very healthy two years after passage of the 1996 Act. The purpose of the universal fund has shifted away from being a safety net needed by high cost customers and toward a mechanism primarily to externalize subsidies and shift some of the subsidies away from incumbent carriers. Universal service support is now being undertaken in preparation for competition, not as a response to competition.

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[10]Comments of MCI at 24.

In this atmosphere, CPI recommends that the Commission draw three conclusions about its program to implement high cost support for non-rural LECs:

- The Commission has the luxury of time to get the new system right. The Commission should not view the January 1, 1999 deadline for resolution of this issue to be binding if additional time would improve the design quality of the federal high cost fund for non-rural LECs.

- The new system must be carefully constructed to ensure that recipients of high cost support do not realize a revenue windfall. Any increased revenues in the federal jurisdiction should be used to reduce customer and carrier access rates; any increased revenues in the intrastate jurisdiction should be carefully monitored by the FCC to ensure that high cost support payments are used to lower prices of services that are providing subsidies today. The incumbent companies do not need or deserve additional net revenues from universal service support.

- The Commission should consider the recommendation of MCI to link the subsidy payments to the degree of deaveraging of prices of unbundled network elements. This will have the effect of increasing competitive opportunities in low cost areas while lessening the opportunities for arbitrage in high cost areas.

Conclusion

CPI appreciates the opportunity to reply to some of the comments on proposals to modify the methodology for determining and distributing federal high cost fund support to non-rural carriers. We look forward to continued discussion with the Commission, the Common Carrier

Bureau and interested parties to develop an effective and equitable federal high cost fund for non-rural LECs.

Respectfully submitted,

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